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Tax Revenue Mobilization in Pakistan: Challenges and Recommendations

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Abstract

Pakistan's economy has been grappling with the challenge of revenue mobilization for decades. This issue has reached a critical juncture where the nation's economic growth, the well-being of its citizens, and even its sovereignty are at stake. Despite numerous policy initiatives and reforms, previous efforts have fallen short of delivering sustainable results. This paper aims to conduct a comprehensive evaluation of Pakistan's revenue mobilization system and identify the critical factors that have been overlooked in past reform endeavors. Our findings suggest that trust is the missing linchpin. Previous reforms have failed to prioritize establishing trust with the most crucial stakeholder in the system: the taxpayer. To address this issue, we recommend that future reform initiatives focus on enhancing governance and structure, improving facilitation, strengthening enforcement and compliance through the implementation of a robust risk management framework, monitoring economic activities and combating smuggling. By prioritizing these areas, Pakistan can foster a more equitable and efficient tax system that promotes economic growth and development.

Introduction

Revenue mobilization has been a longstanding challenge for Pakistan's economy (Cyan et al., 2016). The nation's future, sovereignty, economic stability, and citizen's prosperity are now inextricably linked to successful revenue enhancement (Hasan et al., 2023). Consequently, it has transcended beyond an economic concern to a matter of national security. Previous legislative and administrative reforms, as documented by Bukhari and Haq (2020), have failed to achieve the desired results. A fresh perspective is needed to identify the critical

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factors that have been overlooked in past attempts, particularly regarding the primary stakeholders: the citizens of Pakistan and their inclination towards tax compliance. The following is an excerpt taken from the Report of the Task Force on Reform of Tax Administration in Pakistan (RTAP, 2001):

"Pakistan's fiscal crises are deep and cannot be easily resolved. Taxes are insufficient for debt service and defense. If the tax-to-GDP ratio does not increase significantly, Pakistan cannot be governed effectively, essential public services cannot be delivered, and high inflation is inevitable. Reform of tax administration is single most important task for the government."

It is alarming that the issues highlighted in the RTAP report not only persist but have seemingly worsened over the past two decades. The Federal Government's net revenue, after accounting for provincial shares, now falls short of covering even fifty percent of the expenditures on defense and debt servicing. The figures for the 2023-2024 budget (Table I), as reported by the Ministry of Finance (MoF, 2023), clearly illustrate this concerning trend.

Table 1: Fiscal Outlook

| | 2020-21 | 2021-22 | 2022-23 | 2023-24 |
|---------------------------------|-------------------|-------------------|-------------------|-------------------|
| | Rupees in Billion | Rupees in Billion | Rupees in Billion | Rupees in Billion |
| Tax Revenue Receipts | 4,963 | 6,050 | 7,470 | 9,415 |
| Non-Tax Receipts | 1,610 | 1,315 | 1,935 | 2,963 |
| Total Receipt | 6,573 | 7,365 | 9,405 | 12,378 |
| Less: Provincial Share in Taxes | 2,874 | 3,541 | 4,373 | 5,399 |
| Net Federal Resources | 3,699 | 3,824 | 5,032 | 6,979 |
| Current Expenditure | | | | |
| Defense | 1,293 | 1,373 | 1,567 | 1,809 |
| Debt repayment | 4,359 | 5,575 | 7,884 | 11,748 |
| | 5,652 | 6,948 | 9,451 | 13,557 |
| Others | 3,472 | 3,242 | 1,946 | 4,371 |
| | 9,124 | 10,190 | 11,397 | 17,928 |
| Development Expenditure | 1,137 | 434 | 1,023 | 1,609 |
| Total Expenditure | 10,261 | 10,624 | 12,420 | 19,537 |
| Net Deficit | (6,562) | (6,800) | (7,388) | (12,558) |

Source: Ministry of Finance, Government of Pakistan

The analysis above demonstrates that the Federal Government's net revenue at Rs. 6,979 billion falls significantly short of covering the projected total expenses for defense and debt servicing, which are estimated at Rs. 13,557 billion. Given

past trends, achieving this estimated figure seems highly unlikely. For example, the Federal Board of Revenue (FBR) collection for 2022-2023 of Rs.7,200 billion was revised downward from the initial target, suggesting ongoing challenges in revenue generation. The situation is further exacerbated by the decline in revenue collection when measured in US dollars. From 2020-2021 to 2022-2023, the total collection has decreased by more than a quarter, from US\$23.45 billion to US\$17.56 billion.¹ This stark decline underscores the severity of the revenue crisis and Pakistan's inability to generate sustainable revenues. To address this critical challenge, this article will examine the reform efforts undertaken over the past two decades. We will analyze *why* these efforts have fallen short of achieving desired results and identify the missing elements. This paper seeks to answer the following question: What has led to the stagnation in revenue mobilization, keeping us entrenched in the same quagmire? By delving into these issues, we aim to propose potential solutions that can address the fundamental problems and enhance revenue mobilization within the country.

Reform Efforts in Pakistan

A national government's primary responsibility is to generate sufficient revenue to meet spending requirements, support essential public services, and implement crucial development projects. In both developed and emerging economies, a significant portion of government revenue comes from tax collection (Ahmed & Sheikh, 2011). Effective tax collection is a cornerstone of fiscal and economic development. A robust tax system must be simple, transparent, fair and administratively efficient (SDPI, 2013). Unfortunately, Pakistan's tax system is inefficient, complex, and plagued by administrative bottlenecks. Despite numerous reform attempts by various regimes, substantial progress has been elusive (Hassan et al., 2021).

One of the earliest tax reforms in Pakistan dates back to 1985 when a National Tax Reforms Commission (NTRC) was established. The NTRC recommended a comprehensive overhaul of the direct and indirect tax structures, as well as administrative reforms, including the creation of a new revenue division. Based on these recommendations, the first wave of tax reforms was introduced in the early 1990s. The primary goal was to transform the General Sales Tax (GST) into a Value Added Tax (VAT) and increase the proportion of direct taxes in total tax collection while reducing reliance on excise and trade-related taxes. Subsequent reforms focused on improving transparency, simplifying processes, documenting the economy, reducing tax rates, shifting the tax burden toward consumption and income, and enhancing the overall capacity of the tax administration (Ahmed & Sheikh, 2011).

¹ Year 2020-2021: $3,699/157.74 = \$23.45$ billion
Year 2022-2023: $5,032/286.43 = \$17.56$ billion

Despite these ambitious reform efforts, the Pakistani government failed to achieve its desired objectives (Hasan et al., 2023). In response, the government established a task force in 2000 to identify the core issues plaguing the tax system. The task force highlighted critical areas such as human resources, business processes, information management, taxpayer relations, tax policy, and targets (RTAP, 2001). To address these challenges, the task force recommended reorganizing the board of revenue and incorporating functional specialists in human resources, audit, and information management. Following a comprehensive review and consultation with multilateral organizations, the government launched a fresh wave of reforms focused on policies, legislation, and organizational structures. The aim was to create a simpler and more efficient tax system (FBR, 2020).

The Tax Administration Reforms Program (TARP) launched in 2005, aimed to increase revenue collection, improve the tax-to-GDP ratio, expand the tax base, enhance FBR personnel capacity, improve transparency, and ensure compliance with tax laws (Ahmed, 2018). TARP concluded in 2011 and achieved some positive results, particularly in expanding the tax base through VAT. VAT is a globally significant source of tax revenue, accounting for one-fourth of government revenue on average (Keen & Lockwood, 2010). However, TARP fell short of achieving substantial improvements in overall tax revenue collection (Hasan et al., 2023).

In keeping with a longstanding tradition, the newly-elected Pakistan Muslim League-N (PML-N) government established a Tax Reform Commission (TRC) to propose recommendations for enhancing the transparency and rationalization of the tax system. The TRC identified a significant bias in the tax system that favored the elite and advocated for taxing officeholders, ministers, and judiciary members. The TRC also proposed short- and long-term structural changes to the FBR, including creating a national tax agency responsible for overseeing tax collection at both the provincial and federal levels. Additionally, the TRC suggested strengthening anti-money laundering regulations in accordance with international standards set by the Financial Action Task Force (FATF). Unfortunately, these recommendations were implemented selectively and ineffectively (Bukhari & Haq, 2020).

In 2018, the government prioritized combating corruption and money laundering in Pakistan. A significant step was the implementation of the Benami Transaction Act, passed in 2017. Benami transactions facilitate tax evasion, money laundering, and terror financing. While the Act was dormant, the government operationalized it in 2019. To strengthen the tax structure, the government launched the \$400 million "Pakistan Raises Revenue" program in collaboration with the World Bank (World Bank, 2019). This program focuses on procedural and operational improvements and upgrading FBR's internet and communication technologies. A notable omission in previous reforms was the lack of emphasis on information and data exchange between provinces and the federal government.

The Pakistan Raises Revenue (PRR) project has allocated US\$34 million to address this critical issue.

Why Reforms Failed

This review of Pakistan's tax system and its administrative bodies demonstrates that numerous reform efforts have been undertaken, but unfortunately, they have failed to yield substantial results. Successive Pakistani governments have proposed exciting new reforms over the past decades, but the implementation of these reforms has consistently fallen short of the desired outcomes. This pattern is not unique to tax reforms but has also been observed in other economic reforms proposed by international bodies and donor agencies. The intended objectives of these reforms were also achieved sparingly. While recent efforts such as the Anti-Money Laundering Act, the Benami Act, the OECD's Multilateral Convention on Common Reporting Standards (OECD, 2020), and certain aspects of TARP have shown promise, they have not been sufficient to significantly enhance the tax-to-GDP ratio or generate the desperately needed increase in revenue.

Pakistan's tax-to-GDP ratio has consistently hovered around 10 percent, falling far short of the minimum standard of 15 percent. This ratio pales in comparison to several regional economies, such as India and Turkey, highlighting a significant gap in tax contribution relative to its counterparts. The primary reason for this persistent gap lies in the failure to address the fundamental issues affecting tax collection efforts. Moreover, these reforms were often implemented in a piecemeal fashion, focusing on low-hanging fruits rather than addressing the more challenging and systemic issues.

Previous reform efforts have failed to prioritize building trust with the key stakeholder: the taxpayers. Researchers have observed low tax morale and a decreased willingness to pay taxes (Cyan et al., 2016; Kamal, 2019). The current structure lacks meaningful engagement between taxpayers and government bodies, including the FBR (Marwat et al., 2023). Taxpayer engagement is limited and primarily focused on the budget-making process. Establishing trust and support from the state is essential for taxpayers to fulfill their obligations (Hasan et al., 2023; Ogbonna & Appah, 2016). Without the state's willingness to address these concerns, improving the revenue mobilization situation will remain an uphill challenge.

The current structure raises serious concerns about the FBR's ability to handle core functions effectively. Addressing the challenges related to capability, capacity, and governance within the FBR is imperative. A comprehensive approach is needed to address issues related to human resource management, governance, autonomy, and oversight in the short, medium, and long terms. Partial or incomplete implementation of administrative reforms can undermine

overall efforts and may even have counterproductive consequences. Consistency and full execution are crucial for successful reforms.

Pakistan's tax authorities are only capturing half of their potential revenue (World Bank, 2019). The estimated tax revenue potential stands at 26% of GDP, while the actual collection is only 12.9%. The significant gap underscores the urgent need for the FBR to accelerate digitalization, modernize outdated operational procedures, and adopt the latest tax administration practices, particularly those rooted in big data and business intelligence.

Moreover, there is consensus among various stakeholders that the FBR's inability to guarantee taxpayer compliance is a significant challenge facing the national tax system. Numerous efforts have been undertaken to enhance and modernize this function, but they have fallen short of achieving acceptable levels of taxpayer compliance. This is reflected in the low tax-to-GDP ratio.

Lastly, smuggling has been a persistent problem for Pakistan's economy since its inception. Despite repeated calls from successive governments, efforts to address this issue have consistently failed. The fundamental cause for this persistent challenge lies in the disjointed operations of over two dozen government agencies, which lack proper coordination. The absence of streamlined human resources, logistical support, weak prosecutions, and inadequate monitoring of cross-border activities are key factors contributing to the prevalence of smuggling in Pakistan.

The Way Forward

In today's world, a state's success hinges on the effectiveness of its fiscal policy and management. To collect revenue, a nation-state requires three fundamental elements: the capacity to monitor the wealth created by its citizens, the capacity to tax that wealth, and the trust of its citizens (Steinmo, 2018). A successful state needs three sets of conditions to achieve these goals: delivering value for tax collection, having efficient administrative and monitoring systems, and practicing procedural fairness. Without strengthening these three pillars, significant improvements in resource mobilization will remain elusive. It is time for deeper, faster, more radical, and ambitious reforms to create an independent, strong, and efficient institution. This institution must enjoy the trust of its citizens, be professionally skilled, and be highly adaptable to a rapidly changing environment. The following sections discuss the key areas where reforms are needed to address this situation.

Building Taxpayer Trust

Recent research in revenue mobilization highlights the importance of 'tax morale' (Matthaei et al., 2023). Tax morale is the intrinsic motivation to pay taxes rather than relying solely on enforcement and compliance (Horodnic, 2018). Empirical

evidence suggests that states cannot truly achieve revenue mobilization without building a consensus with taxpayers (Luttmer & Singhal, 2014). Social scientists worldwide have moved away from the traditional economic theory that views humans as inherently selfish creatures who only pay taxes out of fear of punishment. In modern states, governments must convince citizens about the benefits of taxation to win their trust and gain their willingness to pay taxes. This requires a leap of faith (Steinmo, 2018).

Levi (1988) proposes the concept of 'quasi-voluntary compliance', suggesting that tax compliance is a financial exchange where individuals will only comply and contribute if they perceive a benefit. If taxpayers feel they are bearing an unfair burden, they will resist paying taxes. This perspective views taxpayers as strategic partners who will only comply if others are also complying (Steinmo, 2018).

Sweden's tax gap of 6% is one of the lowest in the world, and its citizens are among the most compliant taxpayers (OECD, 2020). Sweden is a prime example of a state that has achieved a high equilibrium of compliance (Steinmo, 2018). By earning the support and trust of its people, Sweden has been able to reduce monitoring costs and improve service delivery. Swedish citizens perceive that the state treats them equitably and provides value in return for their tax compliance.

Recent international literature highlights the critical role of public trust in any tax reform (Prichard et al., 2019). The World Bank emphasizes that effective reforms require political support, taxpayer trust, and a fiscal contract ensuring service and accountability. The World Bank proposes a framework that integrates these factors and translates research findings into practical guidelines (World Bank, 2019). Furthermore, it suggests that investing in trust, facilitation, and enforcement can improve enforced compliance, enhance quasi-voluntary compliance, strengthen financial contracts, and foster continued political support for reforms. Figure 2 provides a detailed examination of each component of this framework.

It is worth exploring whether there is a direct link between taxpayers' trust in the state and their commitment to pay taxes. Does increased trust in the political government, executive machinery, judicial system, and tax authorities lead to more effective compliance? We analyzed World Values Survey (WVS) data with tax compliance, measured by the tax-to-GDP ratio. Figure 3 reveals a strong correlation between a country's tax-to-GDP ratio and its people's trust in the government, civil service, and judicial system. This suggests that increased trust in these institutions stimulates the willingness to pay taxes and enhances tax morale.

It is also worth noting that taxpayers play a crucial part in the tax collection exercise. Compliance with indirect and direct taxes in Pakistan is largely voluntary. Taxpayers deposit most taxes, both as advance taxes and with returns on a voluntary basis. Table II shows that a significant portion of tax collection is

deposited voluntarily by taxpayers. While taxpayers generally have the willingness to pay their legitimate taxes, distortions and unfavorable circumstances can hinder compliance. The lack of a level playing field provokes taxpayers to evade taxes and avoid compliance.

Table 2: Voluntary Tax Collection

| Year | Total Tax Collection | Collection on Demand | Voluntary Collection | |
|------|--------------------------|----------------------|----------------------|----|
| | <i>Rupees in billion</i> | | | % |
| 2013 | 1939 | 89 | 1850 | 95 |
| 2014 | 2266 | 81 | 2186 | 96 |
| 2015 | 2590 | 115 | 2474 | 96 |
| 2016 | 3112 | 88 | 3024 | 97 |
| 2017 | 3368 | 93 | 3275 | 97 |
| 2018 | 3842 | 104 | 3738 | 97 |
| 2019 | 3829 | 103 | 3726 | 97 |
| 2020 | 5555 | 61 | 5494 | 99 |
| 2021 | 4963 | 80 | 4883 | 98 |
| 2022 | 5829 | 101 | 5728 | 98 |

Source: FBR Yearbooks (2021-22 and previous issues)

Tax morale is a cornerstone of the state-building and state-citizen relationship (Belmonte et al., 2023). To implement meaningful tax policy reform, the federal government must prioritize ongoing dialogue with all stakeholders and revise its fiscal agreement with the people. The state should empower Parliament, the judiciary, civil society, and the media to hold the government accountable for its tax collection, spending, and any potential corruption. The budget-making process must be fully transparent, and the state may consider linking its revenue to expenses. Taxpayers must be assured that their tax money is used for the collective good. Benjamin Franklin, a founding father of the United States, famously observed that there is nothing inevitable in this world except death and taxes. We must instill this understanding and doctrine in our youth from a young age. The philosophy of taxation and its role in nation-building should be integrated into the national educational curriculum. However, it is currently impossible to pay taxes honestly in the prevailing circumstances.

The business landscape is significantly disrupted by smuggling, high tax rates, tax evasion, and corruption within the FBR (Chaudhry & Munir, 2010). This makes it extremely challenging for any willing taxpayer to bear the current tax burden equitably, often leading them to become part of the problem. Every business entity in the organized sector is eager to meet its legal obligations, provided there is a fair and level playing field and tax compliance does not render their operations unsustainable. The business sector generally lacks confidence in the system, as the state has not actively engaged with it to address these challenges and create a conducive environment for tax payments.

Given the enormity of the problem, it is recommended that the government establish a truth and reconciliation commission to engage with diverse stakeholders. The commission should convene representatives from all sectors of the economy to understand their concerns and challenges. Subsequently, it should propose potential solutions to shape tax policy development through collaborative efforts with stakeholders. Ideally, the commission should consist of representatives from Parliament, the FBR, tax professionals, and trade bodies.

Furthermore, it is crucial for tax laws to be simple and easily comprehensible, facilitating taxpayers' compliance with ease. A conscious effort is needed to keep the law simple and clear of any ambiguities. The income tax return is the main interface of the FBR with the taxpayer, but it is very complicated. It cannot be filled by individuals or small businesses themselves unless they hire taxation experts. Efforts should be made to make the income tax return as simple as possible and available in all regional languages. Taxpayers lack confidence in the FBR, viewing it as an entity stuck in corruption and primarily interested in extracting taxes, whether lawful or not. Hence, concerted efforts are needed to transform this perception. The FBR should prioritize offering support to taxpayers in fulfilling their tax responsibilities. It should also improve its conduct and approach by practically taking necessary steps as a matter of policy to win the trust and hearts of the taxpayers.

Enhancing Governance and Organizational Structure

Despite significant time and resource investments in developing an effective governance and oversight structure of the FBR, there have been limited improvements. Consequently, it is crucial to examine the FBR's governance structure in detail and propose solutions to address its shortcomings in terms of structure, policies, and procedures.

FBR Headquarters

Efficiency and effectiveness in revenue administration are heavily influenced by robust headquarters. As part of the Tax Administration Reforms Program (TARP), the FBR was restructured along functional lines at the field formation level. However, while the FBR operates with a functional hierarchy at the top level, this organizational structure is not consistently reflected in field formations. Headquarters are linked to the field formations through the centralized authority of Member Inland Revenue (IR) and Member Customs. Member Taxpayer Audit and Member Legal act solely as policymakers and do not participate in the implementation, supervision, or management (Hasan et al., 2023). This formation creates a disconnect between the functional departments at the headquarters and functional lines at the field formation levels, hindering compliance and enforcement efforts. This is a significant issue that requires immediate resolution.

Under the current structure, the Operational Members² effectively serve as the supervisors of the field formations, regardless of their functional line. The other functional members are linked by dotted lines and have minimal influence over field formation officers. Due to the nature of their roles, operational members experience excessive workloads and primarily focus on achieving tax targets. Consequently, all other critical functions are sacrificed. This distortion contributes significantly to several challenges faced by the FBR.

Another crucial aspect, the expansion of the tax base, is overseen by a Director General, who also reports ultimately to the Operational Members. The failure to significantly expand the tax base reflects the lack of prioritization of this critical area within the existing setup. Furthermore, the FBR headquarters also faces limitations in terms of both professional expertise and technical capabilities (Ahmed, 2016). Consequently, there is a lack of necessary professional leadership and efficient supervision to implement taxpayer risk and compliance programs.

Within the current organizational structure, the FBR chairperson is heavily burdened with routine responsibilities such as attending formal meetings across various federal ministries and parliamentary proceedings, which leaves limited time to focus on the fundamental role. A senior-level support function is urgently required to assist the chairperson in effectively fulfilling their duties and addressing succession planning for this vital position. Contemporarily, most tax administrations are semi-autonomous, functioning independently and reporting directly to the state (Fjeldstad, 2014). Considering the scope and complexity of the laws to be administered, revenue administrations must cater to a diverse client base, therefore, they require sufficient authority and independence to operate efficiently and effectively. These organizations follow a business model that is free of perceived political interference and civil service regulations, recruit the best talent, reward according to market standards, and dismiss the "non-performers".

There is a necessity to transform the FBR into a semi-autonomous institution through legislation passed by Parliament. An autonomous board should oversee this restructured body. The board should consist of the chairperson, vice chairperson, and all relevant members. The role of the vice-chairperson holds significant importance in effectively assisting the chairperson in carrying out the organization's core functions.

The tax administration should be reorganized into four functional divisions: Operations/Enforcement, Taxpayers' Audit, Registrations³, and Litigation Support. Each division should have dedicated staff at the field-formation level with direct reporting lines to their respective functional heads. This restructuring will enable

² Member Inland Revenue and Member Customs

³ Aimed at expanding the tax base.

the development of risk-based compliance programs within each division, fostering complete ownership and accountability for these programs. Additionally, the Inland Revenue headquarters should maintain a well-structured audit function that regularly communicates with field audit units. This function should engage in strategic discussions, provide case guidance, and monitor audit outcomes. To fully realize the benefits of functional specialization, the headquarters should directly supervise and coordinate with junior auditors at field formations.

Policy & Oversight Board

Tax policy plays a pivotal role in a nation's economic policy and planning (Bird & Wilkie, 2013). In developed countries, various stakeholders actively participate in policy formulation. Historically, this process was hampered by a lack of democratic foundations, transparency, and autonomy. Consequently, potential tax revenue was lost due to inadequate policy development, which is essential for sustained long-term revenue growth (King & Rebelo, 1990).

The FBR lacks essential strategic oversight to assess its performance in fulfilling legal obligations. The Directorate of Internal Audit, tasked with conducting internal audits and reporting to the chairperson, has failed to achieve its intended objectives of enhancing efficiency and accountability. Instead, its operations have become counterproductive. The Parliament oversees the FBR through external audits by the Auditor General of Pakistan (AGP), which have also been ineffective, wasting resources without any resulting improvements (ICAP, 2016). Reviews conducted by both the finance ministry and Parliament are limited, primarily focusing on overall tax collection figures. These reviews do not provide comprehensive supervision of the entire workflow, which lies at the core of many issues within the FBR.

Developed jurisdictions have implemented robust oversight mechanisms for their revenue services (Crandall, 2010). These countries have well-organized supervisory bodies tasked with scrutinizing the operations of revenue agencies. In the United States, the Department of Treasury Inspector General for Tax Administration (TIGTA) was established by Congress in 1998 with a legal mandate to protect the integrity of the tax system. TIGTA provides independent audit and investigative services to enhance the efficiency, economy, and effectiveness of the Internal Revenue Service (IRS) (George, 2006). TIGTA's oversight functions focus on identifying systemic inefficiencies with high risks in IRS operations and investigating vulnerabilities in tax administration.

It is imperative that policymakers remain independent from the tax administration. The Policy Board, established under section 6 of the Federal Board

of Revenue Act, 2007,⁴ should have been a collaborative platform for shaping national tax policy by engaging with various stakeholders (Hasan et al., 2023). However, section 6 has limited the board's role to that of a facilitator, providing guidance on fiscal policies. This section should be revised to expand the board's responsibilities and allow it to actively contribute to the creation of fiscal policies. The current board composition, which includes the Minister of Finance and several Federal Ministers, as well as the chairpersons of the relevant parliamentary committees, has hindered its effectiveness in achieving the desired objectives.

The Policy Board should be led by the Minister for Revenue/Finance and comprise a panel of 8 to 12 members representing a diverse range of stakeholders, including Parliament, executives, civil society, and the public and private sectors. Potential members could include the chairpersons of the respective finance committees of both Houses of Parliament, the Minister of Commerce, the Deputy Chairperson Planning, prominent economists, intellectuals, technocrats, tax experts, and businesspeople. This board should oversee the FBR's activities and conduct ongoing assessments of its procedures, policies, budget allocation, and progress in achieving national goals. It has the potential to substantially improve the FBR's performance, serve as a watchdog for the state, and submit an annual report to Parliament.

Human Resource Management

Historically, human resource management (HRM) at the FBR has been largely overlooked in reform processes. The FBR needs the authority to recruit top talent and the ability to train and retain it. Currently, FBR personnel are selected through a civil service recruitment process and have diverse educational backgrounds (Ahmed, 2016). They undergo a six-month general training program followed by an additional six months of specialized training at the Inland Revenue Academy and Customs Academy, covering tax, accounting, auditing, and business laws. Given the highly technical nature of the job, the quality of human resources produced through this process is questionable. Many staff members lack a background in business or accounting, requiring them to be trained in forensic audits, advanced accounting, and law. In today's era of digitalization, e-commerce, and online banking, it is evident that the current staff produced may be incapable of performing the necessary tasks.

Tax audits are essential for any revenue service, especially in self-assessment systems (Fatt & Khin, 2011; Wadesango et al., 2018). They are effective tools for ensuring legal compliance and addressing underreporting issues. Currently, approximately two thousand officers oversee this critical task, and there is a significant shortage in the capacity to conduct meaningful tax audits, both at the central office

⁴ As modified by the finance Act, 2007.

and in field formations. An examination of the FBR staff composition reveals that over 90% of the workforce occupies positions at grade 16 or below, totaling approximately 20,000 individuals. In contrast, the total number of officers in grades 17 and above is 1,966. This staffing profile highlights significant operational issues. The absolute figures and the ratio of support to professional staff are unsustainable (ICAP, 2016). This ratio indicates a surplus of human resources within the organization, which lack the necessary skills, and this surplus can be counterproductive.

Evidence suggests that insufficient wages and a lack of accountability are key factors contributing to corruption within the FBR (RTAP, 2001). As a remedy, compensation for FBR employees was aligned with the fiftieth percentile of local banks' salaries, but the results were mixed. While all employees received salary increases, these were not considered rewards for performance and did not yield the desired outcomes. Additionally, the FBR has never conducted a comprehensive job analysis, and job descriptions (JDs) have not been developed and provided to the Federal Public Service Commission (FPSC) for officer recruitment. There is also a lack of career planning and an effective performance measurement system within the FBR. Job performance is not linked to promotions, and there is no structured training program at the FBR.

A comprehensive and holistic rehabilitation of human resource management is needed, encompassing recruitment, training, performance evaluations and promotions. The FBR must develop comprehensive plans to address these pressing human resource management issues, including short-term, medium-term, and long-term strategies. As an interim measure to address current challenges, the FBR should consider recruiting professionals on a contract basis, specifically for management positions (MP grades),

In the short to medium term, the training directorate's curriculum must be revised, and training programs must be intensified. Specialized training should be extended to eighteen months to enhance the technical expertise of new officers, followed by a mandatory six-month practical training period before formal assignments. Training should be an ongoing process within the FBR, and individual performance in these programs should be a factor in future promotions.

In the medium term, the Federal Board Revenue Act 2007 should be amended to allow for the hiring of highly skilled professionals at market-driven salaries. This initiative will enhance the management capabilities at the FBR's headquarters and improve its audit and compliance functions at field formation levels. In the long term, establishing an autonomous tax services cadre, separate from other civil service entities, with its own set of regulations and guidelines, is essential. This would require a comprehensive overhaul of the Directorate of Training, transforming it into a center of excellence.

Accelerating the Pace of Digitalization

Given global trends and the shifts towards digitalization, it is nearly impossible for any state to track economic activity and wealth creation without leveraging technology. Contemporary tax administration reforms worldwide emphasize information technology (IT), offering opportunities and innovative solutions to support tax revenue generation (Kloeden, 2011). In Pakistan, productive digitalization reforms have not only automated antiquated processes but have also significantly transformed the entire system, including electronic tax payments, electronic filing of tax returns, and eliminating unnecessary information requirements for taxpayers (Batool et al., 2021). Digitalization has reduced compliance costs for both the government and taxpayers. However, these reforms have been limited to data collection and storage and have not been fully utilized for resource mobilization. Governments can enhance tax policy implementation through improved information control and more robust systems (World Bank, 2018). Tax administrations can achieve remarkable results by effectively using information technology in all tax domains, particularly in broadening the tax base, enforcement, and taxpayer facilitation (Campbell & Hanschitz, 2018). These efforts are crucial for improving compliance and increasing the country's tax-to-GDP ratio.

Digitalization presents an opportunity to legitimize informal enterprises, broaden the tax base, and enhance tax revenue capacity (Coulibaly & Gandhi, 2018). Streamlining processes and reducing the costs associated with formalization can encourage businesses to transition into the formal sector. Encouragingly, Pakistan has made progress in this direction by adopting electronic platforms for tax filing, reporting, and payments. According to the World Bank and PwC (2020), one of the most successful aspects of tax reform in Pakistan is the implementation of electronic systems for filing and paying taxes. The Paying Taxes indicator, which measures the compliance cost of tax obligations, including tax return filing and payment, shows that Pakistan ranks last overall (see Figure 4).

The continued decline in the time required to file taxes and the number of tax-related payments made by firms globally indicates the growing use of information technology by both firms and tax authorities (World Bank & PwC, 2020). Since 2004, the worldwide average time to file taxes has decreased by 84 hours, and the number of tax payments has decreased by 10.3. Due to the significant drop in digitalization costs, many businesses are using tax software, while tax authorities are increasingly developing user-friendly online platforms to streamline compliance processes. The Time to Comply indicator measures the number of hours per year to prepare, file, and pay mandatory taxes. The Payments Indicator shows the total number of taxes and the frequency of payments during the tax year. Figure 5 exhibits the Time to Comply and Number of Payments rankings.

To address its IT needs, the FBR established Pakistan Revenue Automation (Private) Limited (PRAL). However, the FBR failed to document its IT policy and business objectives, and there is no mechanism to evaluate PRAL's performance. Moreover, the FBR's takeover of PRAL negatively impacted its professional competence. While the FBR has automated certain core business procedures, such as tax return submissions and the declaration of goods, these systems lack critical functionalities, including tracking tax arrears and effectively supporting business operations.

Technology alone is insufficient for improving performance; it is a tool whose effectiveness depends on its use. Simpler tax systems are more conducive to digitization (World Bank & PwC, 2020). Taxpayers and tax consultants have consistently demonstrated a positive and adaptable response to the IT systems introduced by the FBR over time. Regrettably, the FBR's internal utilization of IT has not yet reached its full potential.

In revenue administration, the most significant improvement in compliance can be achieved through real-time exchange and analysis of taxpayer and trader data among the FBR, withholding agents, and provincial tax authorities. The increased storage capacity⁵ and computing power enable tax authorities to more effectively identify instances of tax evasion by capturing and recording a vast number of transactions (Mehta et al., 2019). While the FBR employs three key information and communication technology (ICT) systems with distinct databases managed by PRAL, the automated data exchange between these systems is limited. The FBR has established a national data warehouse, but its coverage and utilization should be expanded by receiving regular electronic data from all sources and employing advanced data mining techniques. Achieving this transformation requires substantial investments in ICT and technical expertise, which is currently lacking within the FBR. Additionally, there is a need to enhance the skills of the FBR personnel to align with automated processes and data-intensive tax administration practices.

The IT systems should be integrated with other national and international databases to gain a comprehensive view of taxpayers and identify potential tax evasion. The FBR should expand its data sources to include datasets from the National Database and Registration Authority (NADRA), State Bank of Pakistan (SBP), motor vehicle registration authorities, utilities, commercial banks, telecoms, and foreign jurisdictions. This will help uncover disparities and irregular patterns that indicate potential tax evasion or other questionable conduct, aiding in identifying individuals or entities operating without proper registration despite having taxable income or sales. This mechanism should be institutionalized by

⁵ By utilizing big data.

regularly transmitting data to the FBR electronically and loading it into the national data warehouse.

The FBR requires significant IT proficiency, primarily due to its key clients, including multinational corporations and large domestic businesses, which employ advanced computer systems that surpass the technological capabilities of the tax administration. Furthermore, the lack of budgetary independence has limited the FBR's ability to replace aging ICT equipment in a timely manner, hindering its technological infrastructure. This situation has resulted in recurring hardware failures and disruptions in the FBR's operations.

Furthermore, sectoral analysis is a valuable tool for determining the taxable income from each sector, identifying discrepancies, and understanding the reasons for revenue shortfalls. To conduct this analysis effectively, a specialized team of tax experts and IT professionals with in-depth sector-specific experience is essential.

Beyond taxpayer registration, tax administration must evaluate compliance with legal obligations. Therefore, an audit and fraud investigation program based on clearly defined risk assessment criteria is essential. By transitioning to technology-driven audits, the FBR can reduce the number of audits, target high-risk taxpayers more effectively, and build trust among compliant taxpayers. Integrating modern technological features, especially big data management and smart portal solutions, will enhance staff productivity and effectiveness, improve service delivery and modernize tax administration.

Improving Tax Compliance

Taxpayer compliance is fundamental to any nation's tax system (Abdu & Adem, 2023; Rahayu et al., 2017). Ideal compliance means that every individual and business should fulfill their tax obligations, including registration, voluntary disclosure, accurate reporting, and timely payments. These four tax compliance responsibilities are essential for citizens, businesses and revenue authorities. Taxpayer compliance is a prime objective for revenue authorities. RTAP (2001) states:

"The primary goal of a revenue authority is to collect the taxes and duties payable in accordance with the law and to do this in such a manner that will sustain confidence in the tax system and its administration. The action of taxpayers - whether due to ignorance, carelessness, recklessness, or deliberate evasion- as well as weakness in a tax administration means that failure to comply with the laws are inevitable? Therefore, the tax administration should have in place strategies and structures to ensure that non-compliance with the tax law is kept to the minimum."

Pakistan faces significant tax collection challenges due to the risk of underreporting and non-reporting. Effective audits can address underreporting, while an effective registration strategy can alleviate the risk of non-reporting. Tax fraud, tax evasion, corruption, underreporting, under-invoicing, and smuggling undermine the tax system. This inequality burdens compliant taxpayers, who face unfair competition from those who evade taxes. The FBR's failure to collect legitimate taxes and meet budget targets negatively impacts the economy, businesses, and taxpayer trust. Consequently, honest taxpayers suffer from delayed tax refunds, including VAT refunds, arbitrary tax assessments, and undue advance taxes due to departmental inefficiencies and tax evasion.

To tackle the compliance issue in Pakistan, the FBR needs a comprehensive compliance risk management framework, as outlined in Figure 6. This framework consists of identifying, assessing, prioritizing, and treating compliance risks. It also includes a range of measures and indicators for each major risk type administered by the revenue body (Chooi, 2020). The FBR should document its monitoring initiatives and results to foster understanding and discussion among diverse stakeholders. To implement this program effectively, the FBR requires appropriate resources and a well-defined strategy.

Combating the Menace of Smuggling

Smuggling refers to importing or exporting goods through illegal channels to evade taxes, including overinvoicing exports and underinvoicing imports (Buehn & Farzanegan, 2012). It raises the cost of conducting legitimate business, weakens the state, hinders development, undermines the rule of law, and perpetuates poverty and instability. Studies worldwide have identified corruption, tariff burden, unemployment, trade restrictions, tax burden, and inflation as factors that encourage smuggling. Conversely, the rule of law and education can reduce smuggling (Aziz et al., 2014; Buehn & Farzanegan, 2012).

Buehn and Farzanegan (2012) developed a smuggling index for fifty-five countries, ranking Pakistan as the worst-performing state. Figure 7 illustrates that the level of smuggling in Pakistan is substantially greater than that its regional peers and countries with similar economic characteristics.

The Model Customs Collectorate (MCC) Preventive in Pakistan investigated thirteen products susceptible to smuggling, finding that eleven of them are significantly involved in illegal trade (Salman, 2018). Table III shows that roughly 60 percent of the overall demand for these eleven commodities, including items like mobile phones, diesel, plastics, auto parts, vehicles, and tires, is fulfilled solely through smuggling activities. This contributes to lower tax revenue, hindering

⁶ These figures are also endorsed by the Overseas Investors Chamber of Commerce and Industry (OICCI).

development and foreign investment. Many foreign investors have left Pakistan due to the difficulty of competing with the profit margins from smuggled goods, making it increasingly challenging to sustain their business operations.

Table 3: Share of Smuggled Products in Formal Sectors

| Products | Smuggling | Formal Imports | Domestic Production |
|------------------|------------------|-----------------------|----------------------------|
| | % | % | % |
| Tires | 59 | 23 | 18 |
| Tea | 47 | 53 | 0 |
| Mobile Phones | 59 | 41 | 0 |
| Television | 57 | 6 | 37 |
| Auto Parts | 57 | 25 | 18 |
| Steel Sheets | 10 | 87 | 3 |
| Vehicles | 12 | 21 | 67 |
| Fabrics | 17 | 25 | 58 |
| Petroleum | 33 | 62 | 5 |
| Cigarettes | 3 | 1 | 96 |
| Plastic Granules | 11 | 63 | 26 |

Source: Salman (2018)

An FBR study found that Pakistan loses \$2.9 billion in tax revenue annually due to the smuggling of just eleven products (Shahbaz, 2016). Figure 8 illustrates the product-wise breakdown of this loss. These products account for 3.88% of Pakistan's GDP⁷. The Lahore Chamber of Commerce estimates smuggling caused approximately \$35 billion in revenue loss from 2001 to 2009. The Device Identification, Registration, and Blocking System (DIRBS) has been effective in curbing mobile device smuggling by restricting unauthorized devices on networks.

Smuggled goods enter Pakistan through porous borders, high seas and containerized cargo, often with full support of the state machinery. The Afghan Transit Trade Agreement (ATTA) facilitates a significant portion of this smuggling (Sultana, 2011). Despite numerous checkpoints, smuggled goods find their way to major cities. Baluchistan's 1,615-kilometer border with Iran and Afghanistan, coupled with limited customs enforcement, creates opportunities for smuggling. The region's lack of educational and employment prospects drives many youths toward smuggling activities like fuel or vehicle smuggling.

To combat smuggling, the government should streamline import duties and establish a unified law enforcement agency. Increased customs inspections and surveillance, especially along western borders, are essential. The FBR should implement a third-party verification system for accurate customs valuations. This validation can guarantee fair, rational, and actual commercial value. Bilateral trade

⁷ Compared to 0.43% in India, 0.04% in Bangladesh, 0.78% in Greece and 0.47% in Ireland.

agreements with anti-smuggling provisions are crucial. Stimulating domestic industry competition, as seen in India, can also help reduce reliance on imports and smuggling.

The FBR should modernize its customs system using cutting-edge equipment and software to facilitate non-intrusive inspections of imported, exported, and transit cargo. This initiative will expedite customs clearance, reduce inspection frequency, and significantly improve fraud detection. Additionally, electronic surveillance of production, distribution, and sales within high-risk sectors such as the tobacco, cement, beverages, sugar, and fertilizer sectors will significantly enhance compliance (World Bank, 2019). Rigorous and independent examinations of under-invoicing during imports will level the playing field for local manufacturers, boosting domestic production, employment generation, and foreign exchange earnings.

The customs wing should be restructured into a functional framework with a strong headquarters. This reorganization will facilitate the provision of top-tier technical guidance to field operations and the implementation of modern risk management strategies in valuation, transactional fraud, post-release auditing, and intelligence efforts. Establishing economic development zones and markets in border regions can create employment opportunities. Closer scrutiny of trade data is essential to mitigate the risk of smuggling through transit trade, which can harm local industries and the national economy.

Conclusion

To achieve successful tax reforms, a new fiscal agreement between the government and its citizens is necessary. This agreement should prioritize creating a fair business environment and making tax compliance a viable option for businesses. By clearly demonstrating the benefits of taxation to every citizen, we can foster voluntary compliance and build a stronger tax system.

Therefore, prioritizing taxpayer confidence is crucial, which has been largely neglected in the past. Gaining taxpayer trust is critical in ensuring voluntary compliance with tax laws. Additionally, strengthening the FBR's governance and organizational structure is imperative. This necessitates substantial reforms and investments to bolster human resource capacity and refine the institution's governance. Transitioning to the third area, prioritizing the improvement of facilitation services through technology investments remains pivotal for the FBR's progress. PRAL needs to be upgraded and strengthened by investing in data warehousing tools that help collect, analyze, and assess taxpayer information. Investing in digital infrastructure and technical proficiency is imperative to unlock efficiency gains, promote paperless administration, ensure real-time interaction

with the FBR field offices, provide robust oversight, expedite data collection, facilitate tax base expansion, and provide e-services to taxpayers.

Fourth, a systematic approach toward improving tax compliance needs to be implemented by utilizing a 'compliance risk management framework'. Additionally, addressing smuggling, both formal and informal, is crucial for any successful tax reform. Pakistan has the potential to increase its tax-to-GDP ratio by an additional 3.9 percent by rigorously enforcing measures and strengthening the roles of the FBR, Frontier Corps (FC), Coast Guard, and Maritime Agency.

The history of past reforms strongly indicates that a comprehensive overhaul is necessary to address the deeply entrenched issues. The FBR should be transformed into a more robust, autonomous professional organization committed to earning the trust of its citizens. It should have an independent human resource function, allowing for competitive compensation and merit-based performance. The reformed FBR should monitor the wealth generated by citizens and ensure tax compliance. It should operate autonomously under the supervision of a robust and effective board and be accountable to Parliament, civil society, courts, and media.

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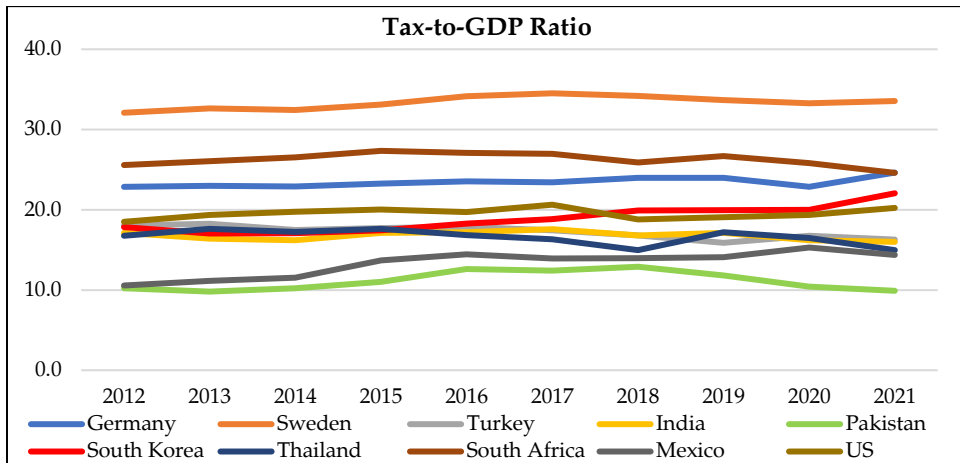
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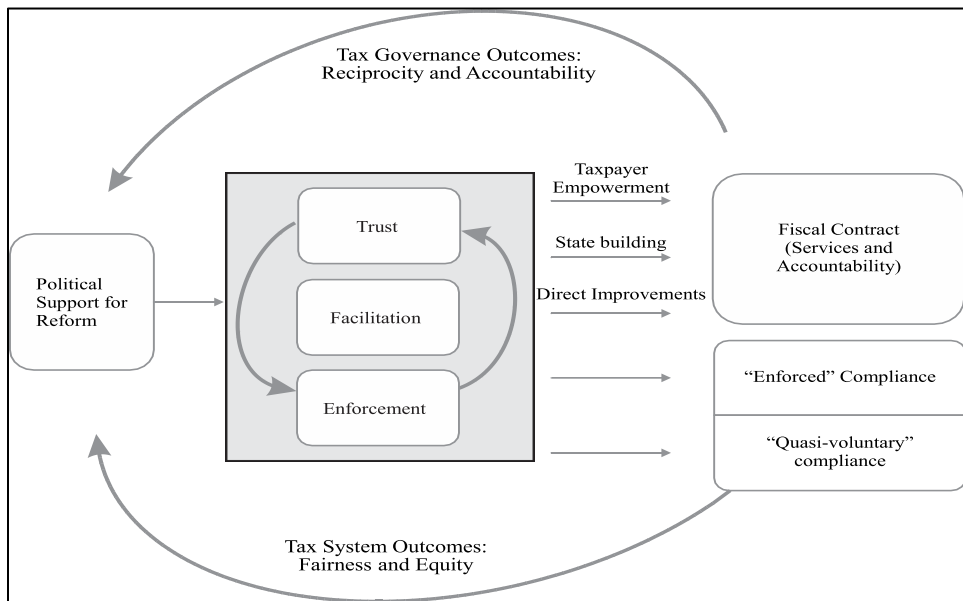
Appendix

Figure 1: Tax-to-GDP Ratio



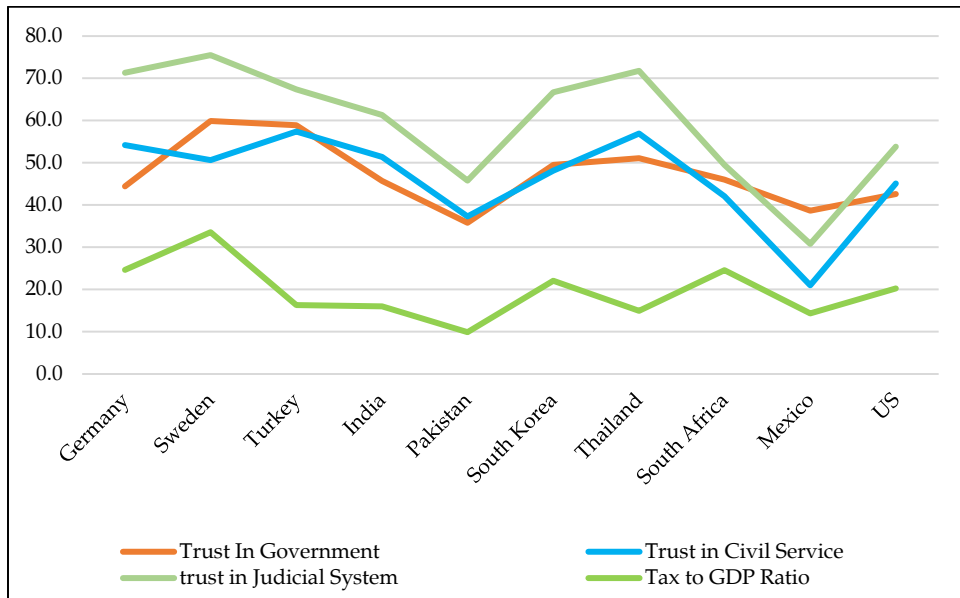
Source: OECD, World Bank

Figure 2: Innovations in Tax Compliance



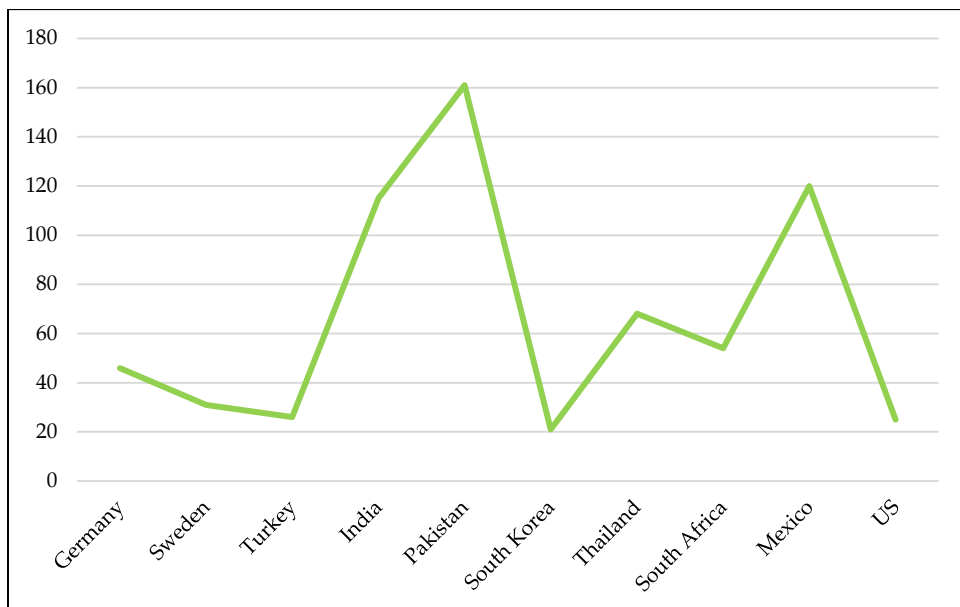
Source: World Bank (Prichard et al., 2019)

Figure 3: Trust and Tax-to-GDP Ratio



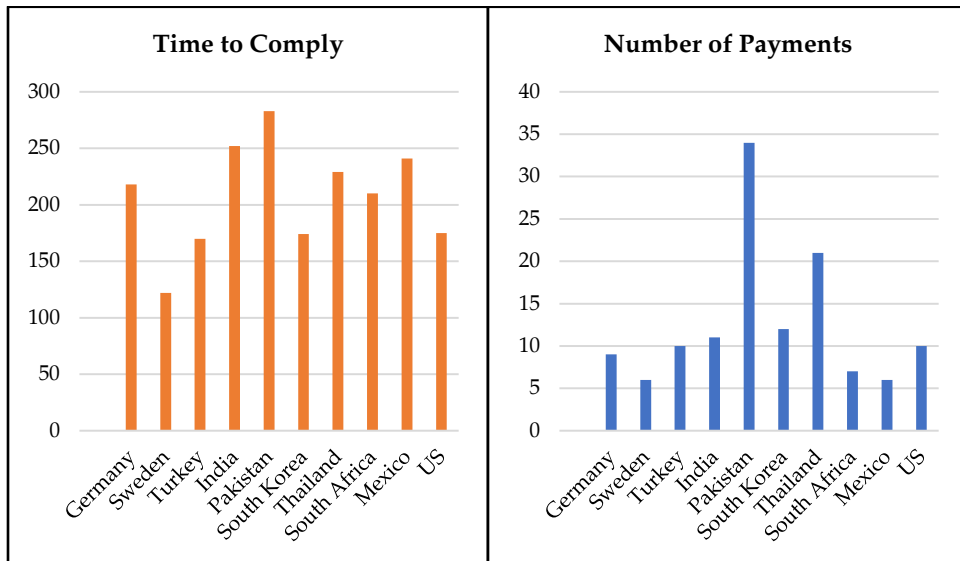
Source: WVS, OECD, World Bank

Figure 4: Overall Paying Taxes Ranking



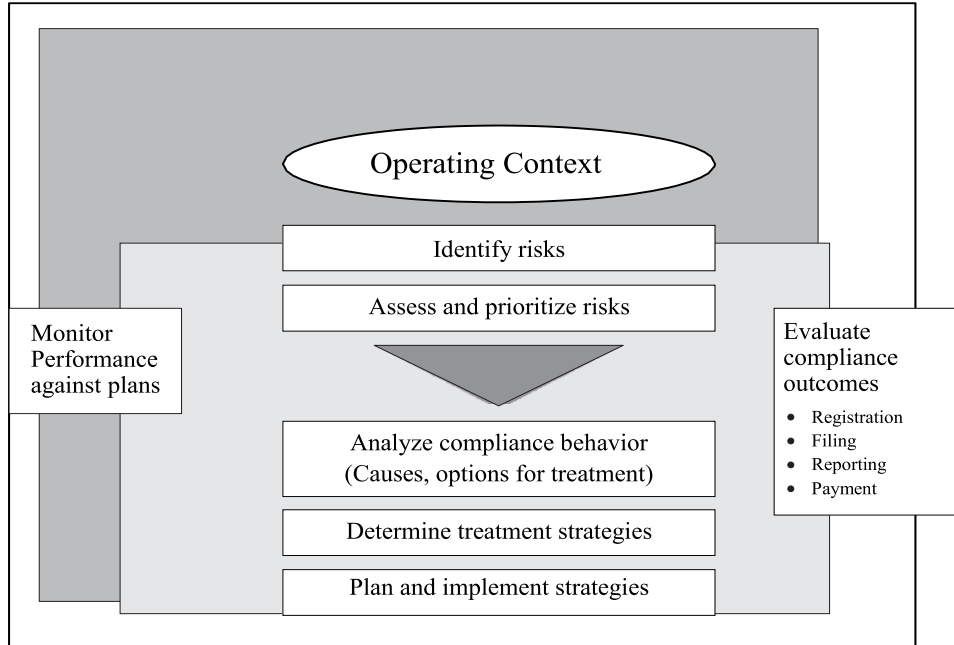
Source: World Bank and PWC (2020)

Figure 5: Time to Comply and Number of Payments Ranking



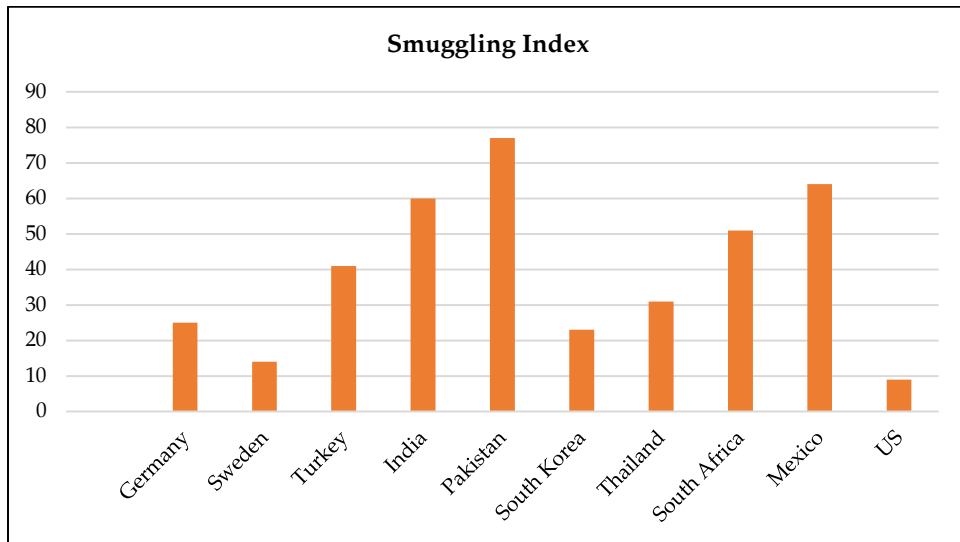
Source: World Bank and PWC (2020)

Figure 6: Compliance Risk Management Framework



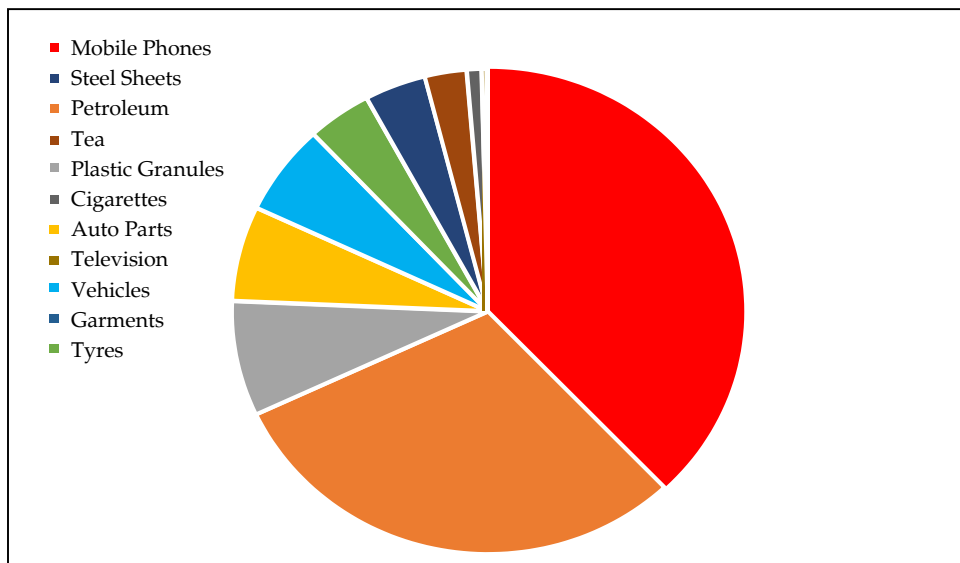
Source: Asian Development Bank (Chooi, 2020)

Figure 7: Smuggling Index



Source: Economist Intelligence Unit (2018)

Figure 8: Product-wise Breakdown of Revenue Loss



Source: Shahbaz (2016)